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No. 91-181

Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

AGRO SCIENCE CO. AND BAVARO INVESTMENT CO.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

R & D PARTNERS-82 AND DONALD D. SPEAR,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ALFA MEDICAL RESEARCH ASSOCIATES AND MARC GELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. WHETHER AT THE OUTSET OF AN INVESTMENT IN A SPECULATIVE RESEARCH PROJECT, THE DEDUCTION FOR RESEARCH AND EXPERIMENTAL EXPENDITURES PROVIDED BY SECTION 174[1] MUST ALSO SATISFY THE PROFIT MOTIVE TEST SET FORTH IN SECTION 183 CONTRARY TO THE PRINCIPLES SET FORTH IN *SNOW V. COMM'R*, 416 U.S. 500 (1974), *rev'g* 482 F.2d 1029 (6th Cir. 1973).

II. WHETHER THE TAX INCENTIVE DESIGNED INTO SECTION 174 IS SUFFICIENT EVIDENCE OF NO PROFIT MOTIVE TO DISALLOW ITS DEDUCTION TO ALL INVESTORS IN A SPECULATIVE RESEARCH PROJECT WITHOUT SEPARATE INQUIRY AS TO THE INDIVIDUAL BUSINESS MOTIVES OF THOSE INVESTORS.

III. WHETHER THE DEDUCTION FOR RESEARCH AND EXPERIMENTAL EXPENDITURES PROVIDED BY SECTION 174 CAN BE DENIED AS A RESULT OF A JUDICIAL DETERMINATION THAT SCIENTIFIC APPROACH UNDERTAKEN WAS FLAWED AND THEREFORE WAS NOT LIKELY TO BE PROFITABLE AND WAS NOT SUFFICIENTLY "EXPERIMENTAL" TO QUALIFY AS RESEARCH, CONTRARY TO THE REASONING SET FORTH IN *SNOW*, *supra*.

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[1]All references to "section" shall be to Internal Revenue Code 1954, Title 26, U.S.C. unless otherwise designated.

IV. WHETHER THE ACCRUAL OF A LEGAL OBLIGATION MAY BE DISREGARDED ON THE GROUNDS THAT (A) THE PRESENT VALUE OF THAT OBLIGATION IS SIGNIFICANTLY LESS THAN ITS FACE AMOUNT OR (B) THE OBLIGOR MAY SATISFY THE OBLIGATION FOR LESS THAN ITS FACE AMOUNT, CONTRARY TO *UNITED STATES v. HUGHES PROPERTIES, INC.*, 476 U.S. 593 (1986).

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

TO: THE HONORABLE WILLIAM H. REHNQUIST, THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The Petitioners named above pray that a Writ of Certiorari issue to review the mandate of the United States Court of Appeals for the Fifth Circuit entered in the above-entitled case on May 2, 1991.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 927 F.2d 213 and is reproduced in Appendix A, page A-1. The decision of the United States Tax Court is reported at T.C. Memo 1989-687 (58 T.C.M. (CCH) 1093) and is reproduced in Appendix A, page A-10.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on March 25, 1991. A timely Petition for Rehearing was denied on April 22, 1991 (Appendix A, page A-49). Mandate was entered on May 2, 1991. The jurisdiction of the Court is invoked under Section 1254, Title 28, United States Code.

STATUTES INVOLVED

I.R.C. section 174 (1954).
I.R.C. section 183 (1954).

STATEMENT OF CASE

These cases were initiated in the United States Tax Court under I.R.C. section 6226(a)(1) (1986) by the filing of three separate petitions from Final Partnership

Administrative Adjustments. The cases were consolidated by Tax Court Order dated April 15, 1987.

FACTS

The Commissioner denied deductions for research expenditures, interest and operating expense claimed by three Texas general partnerships which had been organized to engage in research and development activities through contracts with an unrelated third-party service provider.[2]

Agro Science Company

Agro Science Company ("Agro") was formed as a partnership by individuals and partnerships active in veterinary medicine, cattle raising, ranching and research. In 1982, Agro contracted with Coral to produce a MAB which could identify Escherichia coli K99, the cause of "calf scours", an intestinal disease which attacked young calves and produced severe and often fatal diarrhea.

The Agro partners had learned of the concept of MAB diagnosis from a representative of Coral. On August 7, 1975, Dr. Cesar Milstein, a Brazilian scientist working in Cambridge, England, in conjunction with Dr.

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[2] The service provider, Coral Sociedade Brasileira de Pesquisas e Desenvolvimenta, Ltd. ("Coral"), was a Brazilian company which had research facilities in Brazil and the facilities to produce monoclonal antibodies ("MAB's") and to conjugate them to reagents in its laboratory facilities in Cambridge, England. According to the Tax Court, its staff and equipment were competent and adequate to perform the MAB research contracted for by Petitioners.

G. Köhler, had published a report of success in reproducing antibodies which could identify a specific antigen. Drs. Milstein and Köhler were able to produce a hybridoma cell, which was a virtually immortal reproducer of each "cloned" antibody. If properly refined, an antibody could seek out and attach only to the specific antigen from which it had been developed. (The Tax Court's opinion discusses the research work performed by Coral at length (*Agro Science Co., et al. v. Comm'r*, 58 T.C.M. at 1095, 1103-4).)

As a diagnostic tool, a MAB could be mixed with material of unknown content. If its specific antigen was in the material, the MAB would seek it out and attach to it. That "attachment" could trigger a color change if the MAB had been properly conjugated to a color-reagent. This test could, in a few minutes, demonstrate the presence (or absence) of a particular antigen in blood, urine or other materials. The traditional method of testing required a "culturing" of material to produce a smear which could be analyzed by only a skilled technician. Delay and cost are significant factors in traditional testing.

Agro's research contract with Coral contained the following provisions:

1. Coral agreed to provide facilities and personnel to undertake research and experimentation with the goal of (1) producing a MAB specific only to E. Coli K99[3] and

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[3] MAB's could be produced which would react to more than one antigen. Coral undertook to produce MAB's which were "specific" to a single antigen only. This particular approach was determined by the Tax Court to be a fatal error which would adversely affect marketability

(2) attaching a suitable reagent which would accommodate its use as a therapeutic.

2. Agro agreed to pay a research fee to Coral of N.Cr. $148,920,000 cruzeiros (Brazilian currency) which was equivalent to $600,000 in U. S. dollars. Agro paid U.S. $75,000 of the fee in cash and promised to pay the balance in cruzeiros during the seventh, eighth, ninth and tenth year with interest at 10% per annum. A promissory note was also given by Alfa to further evidence its contractual obligation.

On its 1982 tax return, Agro claimed a deduction for the accrued fee of $593,353.90 which was the U. S. dollar official international exchange rate equivalent of its obligation as of December 31, 1982.

During 1983, 1984 and 1985, the partners of Agro received reports on Coral's progress, designed a packaging machine for the product and awaited the final results of their research project.

In April 1983, a MAB diagnostic product for E. Coli K99 was developed by Molecular Genetics, Inc. of Minneapolis, Minnesota. A patent was applied for which was subsequently granted.

On November 27, 1985, Coral successfully completed Agro's project, whereupon Agro applied for U.K. and U.S. patents. On December 23, 1985, Agro contracted with Technology License Co., Ltd. ("TLC") for evaluation and promotion of its MAB. On March 21, 1986, the Internal

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and thereby denied profit motive.

Revenue Service disallowed the deductions claimed by Agro on the grounds *inter alia* that the entire transaction was a sham, that the partners had no cost basis in their partnership, that the research was not undertaken "for profit," that the partners were not "at risk", that research was not being performed, that the research fee was not accruable because not fixed and determined and that in any event, the accrual method did not properly reflect income.

R & D Partners-82 ("RDP")

This general partnership was formed in 1982. It contracted with Coral to develop a MAB to detect Shigella boydii OC7 conjugated with a suitable reagent for diagnostic purposes.

Unlike Agro, RDP was not composed of experts in the field of its research. Its partners were general investors. On May 16, 1984, it contracted with TLC for evaluation and promotion. U.S. and U.K. patents were applied for when on May 20, 1985, a successfully conjugated MAB was developed. RDP renegotiated its agreement with TLC on December 23, 1985. (T. Ct. Exh. 218) Disallowance of deductions was on April 11, 1986.

Alfa Medical Research Associates ("Alfa")

This partnership was formed in 1982 and contracted for the production and conjugation of a MAB which would detect Pseudomonas aeruginosa 6, a cause of eye infections and blindness. Alfa paid $75,000 in U.S. dollars and agreed to pay additional amounts in Brazilian cruzeiros later. The Tax Court's impartial expert

estimated the cost of producing this particular MAB to be $120,000, exclusive of any profit. (Tax Ct. Tr. (Kennett) 2095). The IRS' expert witness estimated that the cost of developing a MAB was between $60,000 - $70,000 exclusive of any overhead or profit (Tax Ct. Tr. (Norgard) 1809). (T. Ct. Exh. 217) Alfa contracted with T.L.C., Inc. for the promotion of its MAB on September 30, 1985. A MAB was developed for Alfa on November 27, 1985 whereupon Alfa applied for a patent (Exh. 216). The IRS disallowed Alfa's deductions early in 1986.

Coral's Other Research Activities

During the years 1982, 1983, 1984 and 1985, Coral's laboratories in Cambridge, England, employed competent persons and utilized effective technique on its MAB contracts for 170 projects. Coral failed to produce a successful, specific conjugated MAB 30% of the time. *Agro*, 58 T.C.M. (CCH) 1093, 1095 (1989).

Tax Court Decision Below

In January, 1988, the United States Tax Court (B. John Williams, Judge) heard these three "test cases."

On December 28, 1989, Judge Williams ruled:

(1) "Because the Research Notes did not comport with business reality, we hold that they should be ignored (as we believe all the investors intended). Consequently . . .", no accrual is allowed for R & D expense or interest

based upon the amount of research fee not paid in cash.[4] (*Agro*, 58 T.C.M. at 1102).

(2) "We hold that Coral's development of [MAB] conjugates on behalf of Agro, RDP and Alfa does not qualify as 'research or experimental expenditures' as defined in Section 1.174-2(a)(1), Income Tax Regulations," because the process was known, some of the projects were easy to produce, the MAB's "were not obviously useful for diagnostics" because the physician who suspects an E. coli infection will simply prescribe a broad-range antibiotic and not try to be specific and because the lab books were sloppy. (*Agro*, 58 T.C.M. at 1103-1104).

(3) Relying on its holding that the research projects were not scientifically viable, the Court then concluded that no profit could ever result from their development. Because no profit could result, the Court held that no profit motive could exist with regard to Petitioners. ". . . Agro, RDP, and Alfa lacked an actual and honest profit objective in the transactions with Coral and . . . entered into the transactions solely for the tax benefits." (*Agro*, 58 T.C.M. at 1106)

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[4] Judge Williams found that when the contractual obligations were incurred, in 1982 and based on 1982 economic forecasts of future inflation in Brazil, payments aggregating $8,410 would be made on the contracts. He focused on the "Research Notes," although Petitioners relied on the contractual fee to support accrual.

DECISION ON APPEAL

The United States Court of Appeals for the Fifth Circuit affirmed the Tax Court's determination in part. The Court of Appeals held:

(1) That the deferred obligation to pay the research fee could be disregarded for tax purposes because "[n]o one expected to pay any significant part of the $525,000 Research Note debt claimed on the partnerships' tax returns." *Agro Science Co., et al. v. Comm'r*, 927 F.2d 213, 215 (5th Cir. 1991). The Court concluded, therefore, the debt was not genuine.

(2) The expenditures were not made "primarily in furtherance of a bona fide profit objective independent of tax consequences."

With regard to the Tax Court's extensive analysis of the scientific merits of Coral's MAB research, the Court of Appeals made only this comment: ". . . We caution the Tax Court against employing its ill-suited forum to distinguish science from folly, except possibly in the most extreme cases."[5]

REASONS FOR GRANTING WRIT

This case involves an attempt to use tax incentives to finance research in a new area of biomedical science. Every dollar of expenditure was denied deduction because a "tax shelter" was involved. If the separate elements of law announced below are preserved for application

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[5] *Agro*, 927 F.2d at 216, n. 2.

elsewhere, major rulings of this Court will be overturned: (1) the section 174 standard of profit motive as unambiguously announced in *Snow v. Comm'r*, 416 U.S. 500 (1974), *rev'g* 482 F.2d 1029 (6th Cir. 1973) will be replaced with the hobby loss tests of section 183. As a result, taxpayers who invest in a speculative research project without background in that business will be denied research deductions which are specifically allowable under section 174; (2) the tax incentive designed into section 174 will be evidence of non-profit motive available against all amateur investors; (3) the denial of deduction for research and development expenditures under section 174 as a result of the Tax Court's disagreement with the scientific methods employed and the scientific merits of the research, will absolutely discourage research and development contrary to the express legislative purpose announced in *Snow*, *supra*; (4) the "all events" test of accrual as applied in *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) will be changed to add a subjective "present value" test.

The Petitioners entered into their respective activities with full knowledge that the scientific research involved was speculative but all believed it had significant potential. The Petitioners' investments were encouraged by the existence of tax incentives specifically provided by Congress to induce these risky activities. But Petitioners were denied the advantage of those intended tax benefits in part because the courts below recognized that Petitioners were in fact encouraged by those very benefits. The decisions below are contrary to established precedents of this Court, and also reject the clear and unambiguous intent of the Congress. Those departures from established precedent and the clear legislative intent of the statutory

provisions involved require the exercise of this Court's power of supervision.

I. *THE PROFIT MOTIVE UNDER SECTION 174 MUST BE DISTINGUISHED FROM HOBBY LOSS DISALLOWANCE UNDER SECTION 183.* Section 174 was intended to protect and encourage the amateur research investor. H. R. REP. NO. 8300, S. REP. NO. 1622, 83rd Cong., 2d Sess. 33 (1954). On the other hand, section 183 was enacted for a wholly different purpose. The section 183 standards of current activity and experience in an operating activity were designed to distinguish a business from a pleasurable hobby and to prevent non-business related expenditures from being so disguised and deducted. However, those standards of activity, expertise, effort, previous experience and history, actual profits, financial status and elements of pleasure or recreation (Treas. Reg. section 1.183-2(b) are totally irrelevant in testing the profit motivation of investors in a project to invent a new process or develop a new diagnostic test. Until the success of the research has been established, no activity would be purposeful.

If the decisions for which review is sought are allowed to stand, the provisions of section 183 will subsume section 174. Simply stated, tax motive is always an essential element of a Research and Development activity; that was recognized in *Snow*, *supra*. The vast majority of research projects are not even marginally profitable. The remote opportunity to profit from such an investment would result in little or no active business investment in the absence of tax incentives.

The tests of section 183 are irrelevant to investors in all tax-favored activities. Tax incentives are the inducement to the reluctant investor to channel investments into areas deemed important by Congress. Clearly no court has ever inquired as to the expertise of an oil well investor in the process of drilling or extraction. The benefits of the low cost housing credit do not require a demonstration that the investor is a carpentry expert. Now, however, if the section 183 tests for profit motive in research are allowed to stand, only the rarest of such investments will pass muster for deductibility.

This Court has agreed that section 174 standards are to be applied differently. In *Snow v. Comm'r*, *supra*, taxpayer was a Proctor & Gamble executive, not an inventor. The Tax Court and the Sixth Circuit Court of Appeals had disallowed his claim to a deduction for research and experimentation expenses. Those decisions were wrong. "Any small business must start somewhere and that refusal to allow first year development expenditures is inconsistent with the Congressional purpose in adoption of section 174 . . .: 'to prevent tax discrimination between large businesses having continuous programs of research and small or beginning enterprises . . .' 97 CONG. REC. 4326A (1951) (statement of Representative Camp).

This Court reversed specifically because section 174 was intended to "dilute some of the conception of 'ordinary and necessary' expenses under section 162 . . ." Use of the words "in connection with" rather than "engaged in a trade or business" were significant. The Court reaffirmed that the purpose of section 174 is to "encourage expenditure for research and experimentation."

The Court refused to explore the tests for "hobby losses" under section 183 even though the Court of Appeals had noted Mr. Snow's tax motive and reflected on the conflict between the encouragement of R & E and the avoidance of unintended tax shelters. (*Snow*, 482 F.2d at 1031).

The case at bar is contrary to *Snow*.

II. *PROFIT MOTIVE BASED ON AN ADVERSE INFERENCE FROM TAX INDUCEMENTS MUST BE TESTED INDIVIDUALLY.* Tax favored transactions will always carry with them significant tax motivation. However, one taxpayer's tax motives and advantage may be totally different from other investors in the same project. Tax motive was the critical test applied by the Courts below rather than each investor's research expectations. It is perfectly legitimate to maximize tax advantage so long as non-tax factors and risk are also present. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). The Internal Revenue Code has, since its inception, encouraged and subsidized those taxpayer activities which were deemed at the time to be in the national interest. Mineral exploration, low cost housing, capital machinery replacement and charitable support are among them.

Clearly, the tax subsidy for research and experimentation was intended to be a significant encouragement to non-professionals to invest in this kind of activity. As a result, persons invested in Alfa who had little knowledge of its prospects. But certainly that fact should not affect the objectives of the Agro partners who were totally expert and active in the search for a calf scours diagnostic. The section 174 tax motivation to

amateurs to invest in research projects cannot, of itself, defeat a profit motive honestly held by others investing in a similar venture.

Some of Coral's clients may have enjoyed no tax advantage at all from their research contracts. But the criterion established by the Courts below is based solely on significant potential tax advantage as denying the existence of an actual and honest objective to make a profit. The result is an unfair test of exclusion if any significant tax advantage is possible. Indeed, the Record before the Tax Court established that the very project undertaken by Petitioner, Agro, was developed, patented and profitably marketed by a competitor. By grouping all the Petitioners into a single homogenous mass, the Courts below have completely ignored the expressed intent of the application of the profit motive test of section 174. Even under section 183, each Petitioner's disparate activities must be individually reviewed. If the test applied below stands, those Petitioners whose expertise and experience led them to invest in a marketable product will be subsumed by the motives of those who lack the same level of expertise and experience and may have sought only tax advantage.

In the cases at bar, there was no "circular transaction" involving a license agreement granted when the research contract was signed. Several section 174 cases have held that no trade on business was ever possible because the investors had contracted away any rights to the research product at the same time they entered the research quest. *See e.g., Levin v. Comm'r*, 832 F.2d 403 (7th Cir. 1987) *aff'g* 87 T.C. 698 (1987); *Drobney v. Comm'r*, 86 T.C. 1326 (1986); *Green v. Comm'r*, 83 T.C. 677 (1984). Here, the

business of each Petitioner was free to develop or fail on its own. The value of the research was admitted by IRS and Court-appointed experts. Surely some of the Coral research clients had an honest profit objective. The tax motive of some partnerships cannot destroy the profit objective of all.

Section 183 and its Regulations were designed for a specific and narrow purpose: to prevent taxpayers from claiming deduction for the ongoing operation of enterprises which exist for the personal, rather than the business advantage of the participant. Section 174 has a totally different standard because, until research is completed, activity in the "business" would be futile. Section 174 encourages the beginning of research. *Snow* is clear on this point.

III. *JUDICIAL DETERMINATION OF SCIENTIFIC MERITS IS IMPROPER.* In its decision, the Tax Court held that the nature of the research projects undertaken by Petitioners disqualified them for research and experimental deductions under section 174. The Tax Court's reasoning was based on its conclusion that the scientific *approach* undertaken by Petitioners was flawed, and was accordingly wholly without scientific merit or the possibility of profitable development. The Appellate Court was invited to reverse the Tax Court on this issue on the grounds that the Record before the Tax Court flatly contradicted the Tax Court's holding and that the Tax Court was an improper forum for scientific

determination.[6] The Appellate Court chose not to do so. Therefore, a dangerous precedent now exists: the deduction for research and experimental expenditures now depends on the judicial determination of the propriety and prospects of a particular scientific method or approach.

The Tax Court's holding on this issue was pivotal to its conclusion that no profit motive existed in connection with the Petitioners' activities. In the Tax Court's view, because the scientific approach was, in its opinion, hopelessly flawed, the resultant products would have no significant economic potential and therefore no profit motive could exist.

Once again, the principle announced in *Snow*, *supra*, is threatened. As stated in *Snow*, the clear unambiguous legislative purpose of section 174 is to encourage research. Equally clear is the Congressional directive that it is not within the province of the judiciary to question the reasonableness of a scientific approach or method.[7] Indeed, this is the only reported case where the deduction

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[6] In that regard, the Tax Court found that the production of Petitioners' product was no more than a routine, non-scientific activity. That holding is absolutely contradicted by Ex parte Old, Appeal Number 618-28, 229, U.S.P.Q. 196 (1985) wherein the Board of Patent Appeals concluded that the scientific method relied upon by Petitioners was not routine, but to the contrary, every MAB conjugate was a unique and novel biological reaction.

[7] In the Revenue Reconciliation Act of 1989, P. L. 101-239, 103 Stat. 2325, Congress specifically stated that inquiries into the reasonableness of a scientific approach or method were not to be undertaken. *See also* H. R. REP. NO. 274, 101st Cong., 1st Sess., P. 1203, N. 12 (1989).

for research and developmental expenditures has been denied based on a judicial determination that the scientific concept and the methods employed were not scientifically sound.[8]

IV. *THE "ALL EVENTS TEST" OF ACCRUAL DOES NOT CONSIDER PRESENT VALUE OR "EXPECTATIONS" OF FULL PAYMENT.* Had Petitioners' obligation to pay Coral been payable in U.S. dollars with *no interest* on the deferred balance, that absence of interest would not have required reduction or disallowance of the accrual. *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986). That is clearly the law in the Fifth Circuit. *Lawyer's Title Guaranty Fund v. United States*, 508 F.2d 1 (5th Cir. 1975). In this case, however, that clear principle of accrual has been abandoned by the courts below. They held that the deferred portion of an obligation payable in a foreign currency must carry reasonable interest because otherwise the deferred portion would be of a "present value" so much less than face that no debt exists. That is a fallacious argument as well as a legal error. The absence of interest and resulting decline in present value does not detract from the existence of a true debt and is not

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[8] In *Mayrath v. Comm'r*, 41 T.C. 582 (1964), *aff'd* 357 F.2d 209 (5th Cir. 1966), it was determined that the taxpayer's activities which involved the construction of a luxury house which ostensibly involved "research" was not the type of activity which qualified for the research and experimental deduction pursuant to § 174. Instead, the activities involved in that case were held to be personal expenditures non-deductible under § 262. It should be noted that the Court in *Mayrath* did not disparage the manner in which the house was built, but only that home building was not the type of endeavor encouraged by the statute.

relevant to the legal concept of accrual.[9] Accrual has never had anything to do with the "present value" of an obligation. *Altumor Mfg. Co. v. Comm'r*, 12 T.C. 949 (1949), *acq.*, 1949-2 C.B. 1.

This case was clearly the motivation for corrective legislation in 1986. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Cong., 1st Sess. 1069-1114 (Comm. Print 1987). But even the new legislation would merely authorize the Commissioner to reduce the face amount of an obligation expressed in hyperinflationary foreign currency by increasing the imputed interest rate; the obligation and its deductibility would not be denied altogether. I.R.C. § 989(c)(3) (1986).

In 1982, transactions in a foreign currency were bifurcated. The foreign currency amount was immediately "converted" to its U.S. dollar equivalent for immediate U.S. tax purposes. A later gain or loss on currency fluctuations was separately reported. *Levin v. Comm'r*, *supra*.

It is the face amount .of an obligation which is accrued. *United States v. Anderson*, 269 U.S. 422 (1926); Treas. Reg. §§ 1.446-1(c)(1) and 1.461-1(a)(2).

It was made absolutely clear by this Court that the question of actual future payment is not a proper

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[9] Prior to 1986, the only Code requirements of "reasonable interest" were Section 483 which "imputed" reasonable interest on property sales and Section 1232 which converted "original issue discount" on corporate bonds from capital gain to interest income.

consideration in the accrual test. *United States v. Hughes Properties, Inc., supra.*

The Court of Appeals below concluded that "at the time the partnerships executed the Research Notes,[10] no one expected to pay *any significant part* (emphasis supplied) of the $525,000 Research Note debt claimed on the partnerships' tax returns." *Agro*, 927 F.2d at 215. The Court of Appeals misses the point of accrual. This Court made the rule clear: "But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual . . . 'The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not' . . . . And if any of the events hypothesized by the government should occur, the deducted amounts would qualify as recaptured income subject to tax." (authorities omitted) *Hughes Properties, Inc.*, 476 U.S. at 606.

The Court of Appeals below responds: "This was not a bona fide debt. Rather, this is more like a sham obligation as existed in *Knetsch v. U. S.*, 364 U.S. 361 (1960)." *Agro*, 297 F.2d at 215. However, in *Knetsch*, this Court said that in determining whether a true debt existed, it must put aside the District Court's conclusion that the "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction." *Knetsch*, 364 U.S. at 365. Every taxpayer has the legal right to decrease his taxes so long as what is done was the thing that the statute intended. *Gregory v. Helvering*, 293 U.S. 465 (1935). That

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[10] Actually, it was the contractual obligation to pay the research fee which created the accrual. The notes were mere evidence of that obligation.

must mean that a taxpayer's effort to decrease taxes will not itself be evidence that what he did was contrary to the statute.

In 1982, the partners of Agro, RDP and Alfa could not have known (although they hoped) that inflation would continue in Brazil. This hope was, of course, totally opposed by the Brazilian government for which hyperinflation was a constant horror. In early 1986, to stop this trend, Brazil introduced a new currency (the cruzado) which was fixed to the U.S. dollar and imposed wage and price controls. No further decline in the relative exchange rate of Petitioners' cruzeiro obligation could thereafter theoretically occur. Unpredictably, however, that legislation was not sufficient to stop Brazilian inflation.

Brazil's failure to deal with its inflation was a factor totally outside of Petitioners' control. That fact cannot support the Court of Appeals' conclusion that "no one intended to pay any significant part" of their obligation. *Agro*, 927 F.2d at 215. That conclusion would require evidence of collusion with the government of Brazil.

There are three possibilities: (1) allow the face amount of Petitioners' legal obligation because it complied with the "all events test" of accrual; (2) allow only the "present value" of the obligation using interest rates current in Brazil at the time; or (3) disallow the entire deduction. The last alternative, which was adopted by the Tax Court and the Court of Appeals below, is the only one which is clearly erroneous.

CONCLUSION

One may argue with the efficacy of subsidies which flow from the Internal Revenue Code to favored industries. Some in those industries may unfairly use that tax advantage status to reduce the cost of funding their operations and to increase their profit. But the tax orientation of totally lawful transactions undertaken in good faith by clients of favored industries should not negate the profit motives of those clients. Both profit and tax motives can jointly prompt investment.

Here, the Petitioners entered into legally binding contracts for services to produce qualified research for an agreed research fee. To deny the deductibility of research fees on the stated ground that the taxpayer sought tax advantage virtually overrules *Snow v. Comm'r*, *supra*.

The Courts below apparently rejected the bona fides of Petitioners' transactions on the grounds that fee accrual was in the currency of a country experiencing inflation. The "separate transaction principle" accommodates this situation. This Court's decision in *Hughes Properties, Inc.*, *supra*, makes it clear that both events should be accommodated with recapture rather than the abandonment of the "all events test."

The decisions below would change the law in these ways:

(1) The "hobby loss" standards of business activity will now supersede the "in connection with a trade or business" test as applied in *Snow v. Comm'r*, *supra*.

(2) The profit motives of all investors in a similar investment will be determined without separate factual consideration.

(3) Courts will pass on the scientific, artistic and economic strategies adopted by taxpayers as part of the application of the Internal Revenue Code.

(4) A subjective standard of expected payment based on the present value of a deferred will defeat accrual.

Now, therefore, it is requested that a writ be issued granting certiorari to the Court of Appeals for the Fifth Circuit.

Respectfully submitted,

Joel Held

Dated July 19, 1991

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APPENDIX A

OPINIONS, ORDERS, FINDINGS OF FACT AND CONCLUSIONS OF LAW OF THE COURT OF APPEALS FOR THE FIFTH CIRCUIT

AGRO SCIENCE CO., and Bavaro Investment Co.,
Petitioners-Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

R & D PARTNERS-82, and Donald D. Spear,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ALPHA MEDICAL RESEARCH ASSOCIATES, and
Marc Geller, Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 90-4265

United States Court of Appeals,
Fifth Circuit.

March 25, 1991

On appeal from decisions of the United States Tax Court disallowing partnerships' deductions for expenses incurred in conjunction with research contracts, the Court of Appeals, Reavely, Circuit Judge, held that: (1) debt represented by notes was illusory and partnerships were entitled to no deduction as result of that debt; (2) partnerships did not invest in research projects primarily in furtherance of bona fide profit objective independent of tax consequences; and (3) partnerships were properly treated together in discerning profit motive.

Affirmed.

William D. Wright, William E. Bailey, Bailey, Vaught, Robertson & Co., Dallas, Tex., for petitioners-appellants.

Abraham N.M. Shashy, Jr., Chief Counsel, IRS, Shirley D. Peterson, Asst. Atty. Gen., Dept. of Justice, Tax Div., Kimberly Stanley, Kenneth L. Greene, Gary R. Allen, Chief, Appellate Sec., Tax. Div., Dept. of Justice, Washington, D.C., for respondent-appellee.

Appeals from the Tax Court of the United States.

Before REAVLEY, JONES and SMITH, Circuit Judges.

REAVLEY, Circuit Judge:

The Commissioner of Internal Revenue (Commissioner) issued final partnership administrative adjustment notices to appellants Agro Science Company (Agro), R & D Partners—82 (R & D), and Alpha Medical Research Association (Alpha) (collectively the Partnerships). The Commissioner's notices denied the Partnerships' deductions on their 1982 and 1983 tax returns for expenses incurred in conjunction with research contracts that each executed with Coral Sociedade Brasileira de Pesquisas e Desenvolvimenta, Ltda. (Coral). The United States Tax Court consolidated the appellants' petitions for readjustment, and after trial entered decisions disallowing the Partnerships' Coral-related deductions. We affirm.

I. BACKGROUND

Coral agreed in 1982 to develop a different monoclonal antibody (MAB) conjugate[1] for each of the Partnerships. In exchange, each agreed to give Coral $75,000 cash and execute a $525,000 promissory note in

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[1]MABs are laboratory copies of disease-fighting agents produced naturally in the bodies of humans and some animals. *See United States v. Campbell*, 704 F. Supp. 715, 719 (N.D. Tex. 1988) (explaining procedure Coral uses to produce MAB conjugates), *aff'd as modified*, 897 F.2d 1317 (5th Cir. 1990). Doctors and veterinarians use MAB conjugates to diagnose and treat various diseases.

Coral's favor (a Research Note). Each Research Note was payable in Brazilian new cruzeiros (cruzeiros) over a four-year period beginning seven years from its execution date at an annual interest rate of 10%. In 1982 the cruzeiro was undergoing hyperinflation and devaluation against the dollar, yet the Research Notes contain no inflationary index.

Coral's officers, Allen F. Campbell and Donald Spear, recruited the Partnerships' members, stressing to them the tax advantages of executing the Research Notes. They explained that the consensus among economists was that the cruzeiro would undergo inflation of approximately 80% annually for the foreseeable future. Each partnership deducted its entire $600,000 obligation to Coral, plus interest and expenses, in 1982 and 1983. By 1988, the cruzeiros that cost $525,000 in 1982 could be paid to Coral for approximately $184.

Though Coral fulfilled its contractual obligations by producing MABs for the Partnerships, the Commissioner refused to allow the Partnerships to deduct the payments, debt, and expenses associated with the Coral transactions. After a consolidated trial on the Partnership's petitions for readjustment, the Tax Court held that the debt represented by the Research Notes is illusory, the Partnerships did not contract with Coral pursuant to a bona fide profit motive, and Coral's work for the Partnerships is not research within the meaning of 26 U.S.C. § 174. Accordingly, the Tax Court entered decisions disallowing the Partnerships' deductions.

II. DISCUSSION

A. ECONOMIC SUBSTANCE AND THE RESEARCH NOTES

[1,2] On appeal, the Partnerships do not dispute the following Tax Court findings: 1) Coral's officers promoted the MAB projects primarily as tax shelters and stressed the real inflationary pressures on the cruzeiro; 2) Coral contravened standard Brazilian commercial practice by executing promissory notes in 1982 that did not contain an inflationary correction mechanism; 3) the interest Coral charged on the Research Notes was less than ten percent of the Brazilian market interest rate in 1982; and 4) Coral could have profitably produced each MAB conjugate for well under the $75,000 cash paid by each partnership. These facts demonstrate that at the time the Partnerships executed the Research Notes, no one expected to pay any significant part of the $525,000 Research Note debt claimed on the Partnerships' tax returns.

There is no material difference between the Partnerships' sham research debt and the sham interest payments disallowed as deductions in *Knetsch v. United States,* 364 U.S. 361, 365-66, 81 S.Ct. 132, 135, 5 L.Ed.2d 128 (1960). *See also Levin v. Commissioner,* 87 T.C. 698, 734 (1986) (interest accrued on sham long-term obligations payable in foreign currency undergoing inflation not deductible), *aff'd,* 832 F.2d 403 (7th Cir. 1987). Like the annuity bonds at issue in *Knetsch,* the parties executed the Research Notes exclusively for the Partnerships' tax benefits. A debt created for the exclusive purpose of generating tax savings is not genuine

and must be disregarded for tax purposes. *Campbell,* 897 F.2d at 1321; *Jacobson v. Commissioner,* 915 F.2d 832, 837 (2d Cir. 1990).

We agree with the Tax Court that the Partnerships are entitled to no deduction as a result of the hollow debt represented by the Research Notes.

B. PROFIT MOTIVE AND THE CASH INVESTMENTS

[3] Congress allows deductions under 26 U.S.C. § 162 for expenses of carrying on activities that constitute a taxpayer's trade of business, under 26 U.S.C. § 174 for research and development expenses in connection with a trade or business, and under 26 U.S.C. § 212 for expenses incurred in connection with activities undertaken to produce or collect income. Expenditures may only be deducted under sections 162, 174, and 212 if the facts and circumstances indicate that the taxpayer made them primarily in furtherance of a bona fide profit objective independent of the tax consequences. 26 C.F.R. § 1.183-2(a) (1990); *Mayrath v. Commissioner,* 357 F.2d 209, 214 (5th Cir. 1966); *Drobny v. Commissioner,* 86 T.C. 1326, 1340 (1986).

The Tax Court found that the Partnerships did not intend to profit, except by tax deductions, from their $75,000 cash investments in Coral projects. That finding stands unless it is clearly erroneous. *Masat v. Commissioner,* 784 F.2d 573, 575 (5th Cir. 1986). We think the court's finding manifestly correct.

The Tax Court heard testimony from all general partners willing to testify and concluded that: 1) the partners were unconcerned about the financial condition of their respective partnerships or their fellow partners; 2) the partners had a shallow or nonexistent understanding of their respective partnerships' potential profitability, liabilities, or management; 3) most partners knew little or nothing about the research conducted for them by Coral; 4) some partners attended one partnership meeting while others knew nothing about partnership meetings; and 5) many partners admitted awareness of the cruzeiro devaluation and the promised tax benefits of investment resulting from the Research Notes.

The Partnerships challenge only the relevance of these findings to profit motive, not their accuracy. To us, the advertised eight-to-one tax write-off purportedly facilitated by Coral's cruzeiro scheme indicates why the Partnerships contracted with Coral. Still, contrary to the Partnerships' assertion, the Tax Court appropriately looked to the factors listed in 26 C.F.R. § 1.183-2(b) (1990) in discerning profit motive bona fides. *See, e.g., Tallal v. Commissioner,* 778 F.2d 275, 276 (5th Cir. 1985); *Drobny,* 86 T.C. at 1342. The court did not consider irrelevant factors in concluding that the partners only invested in their respective partnerships to lessen their tax obligations. Even the constituencies of lay partnerships formed to contract for highly speculative, technical research services must take interest in the basic business and profitability of their undertakings to demonstrate a legitimate profit motive. *See generally Drobny,* 86 T.C. at 1343-48. Also, there is no evidence that the Tax Court failed to consider objective facts and circumstances

proffered by the Partnerships to support their profit motive legitimacy claim.

[4-6] Alternatively, the Partnerships contend that it was error for the Tax Court to treat them together in discerning profit motive. We disagree. The profit motive of a partnership is determined at the partnership level. *Tallal,* 778 F.2d at 276. The testimony of general partners and promoters taken as a whole is relevant in determining a partnership's profit motive, because these individuals control a partnership's activities. *Fuchs v. Commissioner,* 83 T.C. 79, 98 (1984).

Agro, R & D, and Alpha executed virtually identical research agreements with Coral. The three agreements differ only in date of execution, MAB description, and promissory note amount expressed in cruzeiros. None of the agreements were negotiated. Coral's representatives simply picked a group of MABs to offer for sale and solicited partnerships willing to sponsor a MAB. Coral sold each MAB project for the exact same consideration in United States currency.

Unlike Alpha and R & D, Agro's partners are involved in the cattle business and the MAB that they selected concerns a cattle disease. But, especially in light of the strong evidence as to tax motive, this distinguishing characteristic is insufficient compared to the other evidence of homogeneity to render the tax court's collective treatment of the Partnerships' profit motive clearly erroneous.

The weight of the evidence indicates that the Partnerships purchased congruous research projects under

identical conditions with the primary intent of realizing tax advantages.

III. CONCLUSION

Our debt-authenticity and profit-motive holdings foreclose all deductions presently at issue.[2] We thus AFFIRM the Tax Court's decisions against each of the Partnerships.

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[2]As in *Mayrath*, our profit motive holding makes it unnecessary to reach the Tax Court's discussion of the bona fides of Coral's research efforts. *See* 357 F.2d at 212 n.3. We caution the Tax Court against employing its ill-suited forum to distinguish science from folly, except possibly in the most extreme cases.

OPINIONS, ORDERS, FINDINGS OF FACT AND CONCLUSIONS OF LAW OF THE UNITED STATES TAX COURT

Agro Science Company, Bavaro Investment Company, Tax Matters Partner, et al.[1] v. Commissioner.

Docket Nos. 22313-86, 22687-86, 22755-86. T. C. Memo. 1989-687. Filed December 28, 1989. [Appealable, barring stipulation to the contrary, to CA-5.—CCH.]

Ronald M. Mankoff, G. Tomas Rhodus, and Brett B. Flagg, 300 Crescent Court, Dallas, Tex., for the petitioners. Pamela V. Gibson, Judy Jacobs, and Kathleen E. Whatley, for the respondent.

Memorandum Findings of Fact and Opinion

WILLIAMS, Judge: In these consolidated cases the Commissioner determined adjustments to the 1982 and 1983 Federal partnership returns for the Agro Science Company ("Agro"), R&D Partners - 82 ("RDP"), and Alfa Medical Research Associates ("Alfa") by denying deductions as follows:

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[1]Cases of R&D Partners - 82, Donald D. Spear, Tax Matters Partner, docket No. 22687-86, and Alfa Medical Research Associates, Marc Geller, Tax Matters Partner, docket No. 22755-86, are consolidated herewith.

Agro

1982

R&D expense	$593,353.29
Accounting fees	4,000.00
Interest	142.03
	$597,495.32

1983

Accounting fees	$ 4,000.00
Interest	22,162.50
	$ 26,162.50

RDP

1982

R&D expense	$600,000.00
Accounting fee	3,400.00
Management fee	900.00
Postage & office expense	91.86
Interest	1,150.68
	$605,542.54

1983

Accounting fees	$ 3,400.00
Administrative fees	900.00
Postage & office expenses	22.39
Interest	21,470.46
	$25,792.85

Alfa

1982

R&D expense	$577,167.80
Accounting fees	2,500.00
Administrative fees	3,150.00
Interest	1,150.00
	$583,967.80

1983

Accounting fees	$ 2,500.00
Administrative fees	2,500.00
Amortization	205.00
Interest	21,470.46
	$26,675.46

Timely final partnership administrative adjustments were received by petitioner Bavaro Investment Company, tax matters partner for Agro, petitioner Donald Spear, tax matters partner for RDP, and petitioner Marc Geller, tax matters partner for Alfa. The issues we must decide are: (1) whether the partnerships' notes to Coral Sociedade Brasileira de Pesquisas e Desenvolvinmenta, Ltd. ("Coral") are valid indebtedness; (2) whether the partnerships incurred research and development expenses to section 174;[2] and (3) whether the research and development agreements at issue with Coral were entered into with a profit objective.

Findings of Fact

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[2]All section references are to the Internal Revenue Code of 1954 as in effect for the years in issue, unless otherwise indicated.

The principal place of business of each partnership was in Texas at the time the petitions were filed in these cases. The partnerships were organized to engage in research and development activities in connection with the development, production, licensing, and marketing of diagnostic health care products utilizing monoclonal antibody conjugates. To accomplish these purposes, Agro, RDP, and Alfa (collectively, the "Partnerships") entered into research and development agreements with Coral.

In 1982 Mr. Allen Campbell formed Coral under the laws of Brazil. Gwynfor R. Williams assisted Campbell in setting up the Coral programs. As of March 1982, Campbell owned 99.875 percent of Coral through Inpro, a Netherlands holding company, owned and controlled by Campbell. Campbell holds a law degree and is the founder and sole shareholder of A. F. Campbell & Co., Inc. ("Campbell & Co."), a corporation formed under the laws of Texas.

Campbell formed Coral to perform the laboratory work needed to make monoclonal antibody conjugates for the Partnerships. Coral had limited laboratory facilities and offices in Sao Paulo, Brazil. No meaningful research or development activities for the Partnerships took place in the Sao Paulo offices. The laboratory work that is the subject of this litigation was performed in Coral's laboratory facilities in Cambridge, England. The staff and equipment in Cambridge were competent and adequate to perform the monoclonal antibody research contracted for by the Partnerships. The laboratory included animal facilities, cell culture facilities, bacterial facilities, immunology facilities, microbiology facilities, and facilities for the purification of antibodies.

Dr. Fred Stark was employed by Coral to set up and manage the Coral laboratory. He had been Assistant Chief of Medicine and Chief of Infectious Disease Service at Letterman Army Medical Center, Associate Clinical Professor of Medicine at the University of California, and a Fellow in Infectious Diseases and Immunology at Walter Reed General Hospital. The full-time researchers at the Coral laboratory in Cambridge included among others, Bruce Wright, who had worked as senior research office in charge of the tissue culture facilities of Dr. Milstein who had been awarded a Nobel Prize for the discovery of monoclonal antibodies. By late 1984, Coral employed approximately 100 people. Coral sold approximately 170 monoclonal antibody production projects to United States investment groups and succeeded in producing monoclonal antibody conjugates for approximately 70 percent of the projects undertaken.

An antibody is a disease fighting component found in the body. When a human's body is invaded by a pathogen (*e.g.*, a bacterium or virus), the body normally responds by making a variety of antibodies to destroy the invading organism. Each monoclonal antibody developed by Coral was a laboratory copy of an antibody designed to bind with a single antigen of an organism.

The source of antibodies is B-lymphocytes ("B-cells"). B-cells cannot grow in culture; so to produce a monoclonal antibody, a B-cell producing a particular antibody is fused with a cancer cell (a myeloma). The cancer cell confers the ability to grow permanently in cell culture and to support unlimited antibody production. The B-cell contributes gene coding for the specific antigen to which

the antibodies will react. The fused B-cell and cancer cell is called a "hybridoma."

In general, the steps of Coral's production of monoclonal antibodies were as follows: (1) obtain a purified antigen, a potentially toxic substance; (2) inject the purified antigen into a laboratory mouse to invoke an immune response in the mouse (usually through the release of B-cells into the blood) directed to a particular antigen; (3) sacrifice the mouse and fuse the sacrificed mouse's antibody-producing cells with a cancer cell to form the hybridomas; (4) place the resulting hybridomas in a cell culture medium for growth or cloning; and (5) test the resulting clones for production of the desired antibody. Each antibody in a mouse has several subclasses of antibody. Coral produced a single subclass of each monoclonal antibody.

Coral would then conjugate the monoclonal antibody. "Conjugation" of a monoclonal antibody refers to the process of coupling the antibody with a substance which allows the antibody to produce a "signal." A monoclonal antibody conjugate is a monoclonal antibody linked to a label or tag, such as an enzyme, capable of providing a signal (such as a simple color change) which indicates a particular antigen/antibody reaction. The Partnerships hoped that a conjugated monoclonal antibody particular to a specific antigen would have potential usefulness (either alone or in combination with other antibodies) in connection with human or animal diagnostics, epidemiology, serological classification or identification, animal therapeutics, and general medical and scientific research.

Coral maintained laboratory notebooks for each monoclonal antibody project at issue. The lab books were divided into sections and contained blank forms to fill in with the project results. The lab books were not complete. Most of the forms were not filled in. Some sections contained only pages of computer printouts with no explanation.

On October 23, 1982, November 29, 1982, and December 23, 1982, Agro, RDP, and Alfa, respectively, were formed as general partnerships under the laws of Texas. The partners contributed to their respective partnerships cash and nonnegotiable, non-interest-bearing demand promissory notes as follows:

Agro

Name	*Initial Capital Contribution*		*Ownership Interest*
Thomas L. Lee	$ 3,450 cash	$ 31,050 note	4.00%
R. R. Finham	3,450 cash	31,050 note	4.00%
Howard Smith	3,450 cash	31,050 note	4.00%
Mameco	3,450 cash	31,050 note	4.00%
Black Gold Prts.	17,250 cash	155,250 note	20.00%
Jo Bar Investments	3,450 cash	31,050 note	4.00%
Joe McQueary	3,450 cash	31,050 note	4.00%
David Hama, D.O.	3,450 cash	31,050 note	4.00%
Walter A. Dobson, D.O.	3,450 cash	31,050 note	4.00%
Martin Greibat	17,250 cash	155,250 note	20.00%
Bavaro Investments	3,450 cash	31,050 note	4.00%
Jesse Lyons	3,450 cash	31,050 note	4.00%
Marvin Jones	3,450 cash	31,050 note	4.00%
Jack Grossman	3,450 cash	31,050 note	4.00%
Donald P. Brotherman, M.D.	3,450 cash	31,050 note	4.00%
Brant Blonkvist, M.D.	3,450 cash	31,050 note	4.00%
Barry Morgan	3,450 cash	31,050 note	4.00%

RDP

Name	*Initial Capital Contribution*		*Ownership Interest*
James E. West	$ 3,269 cash	$ 25,500 note	4%
Robert Winn	3,269 cash	25,000 note	4%
Gary Bergman	4,342 cash	34,000 note	5⅓%
Ruth Hester Sutton	3,269 cash	25,500 note	4%
Reynaldo Perez, M.D.	5,415 cash	42,500 note	6⅔%
Thomas Hennessy	7,561 cash	59,500 note	9⅓%
Edward J. Each	5,415 cash	42,500 note	6⅔%
Everett M. Davis	3,269 cash	25,500 note	4%
Danny C. Wash	3,269 cash	25,500 note	4%
Donald D. Spear	1,073 cash	8,500 note	1⅓%
W.C. Farrill, III	5,415 cash	34,000 note	6⅔%
Ellis R. Hardin	4,342 cash	34,000 note	5⅓%
Roy Wm. Jenkins	4,342 cash	25,500 note	5⅓%
Ben S. Skinner	3,269 cash	25,500 note	4%
James M. Magae	3,269 cash	25,500 note	4%
B.H. Sirmons	10,780 cash	85,000 note	13⅓%
Robert Markovich	3,269 cash	25,500 note	4%
Paul H. DaGroat	3,269 cash	25,500 note	4%
Gordon Lillie, M.D.	3,269 cash	25,500 note	4%

Alfa

Name	*Initial Capital Contribution*		*Ownership Interest*
Derby Producing Co.	$31,398.00 cash	313,980.00 notes	35.39%
Alan Faden	14,666.66 cash	146,666.60 notes	16.53%
Marc Geller	14,666.66 cash	146,666.60 notes	16.53%
Bill J. Sitzes	14,666.66 cash	146,666.60 notes	16.53%
Marion & Lura Griffin	13,327.00 cash	133,270.00 notes	15.02%

The Articles of Partnership for Agro and RDP delegated the administration of the day-to-day affairs and ministerial acts necessary to conduct partnership business to Bavaro Investments Partnership and Donald Spear, respectively. Donald Spear was the tax matters partner for RDP and also was a salesman for Coral. On December 23, 1982,

Alfa entered into an agreement with Medical Research Funding, Inc., d/b/a Houston Research Associates ("HRA") to assist in managing and administering partnership business. The agreement for these services was signed on behalf of HRA by Mr. S. M. Neider.

In December 1982 the Partnerships entered into similar research and development agreements with Coral. The research agreements were identical except for the date, the consideration denominated in Brazilian new cruzeiros (NCr$, hereinafter "cruzeiros"), and the product description. Pursuant to the agreements, Coral was to diligently conduct for 12 months or until completion of the project, whichever first occurred, the "research and experimentation" necessary for the development of a particular monoclonal antibody conjugate. The agreements did not require that Coral produce more than one subclass of the monoclonal antibody or specify which subclass of monoclonal antibody Coral would produce. Coral at its option could extend the term of the agreement with each partnership for two additional 12-month periods.

The research agreement between Agro and Coral describes the product to be developed by Coral as:

> A conjugate of Alkaline phosphatase and a monoclonal antibody which is produced by a single mouse/mouse hybrid cell line and which combines specifically in an immunological manner with the characteristic antigen of Escherichia coli K99.

In exchange, Agro agreed to pay Coral NCr$148,920,000 for its services, payable one-eighth in cash upon the execution of the Agreement and seven-eighths by execu-

tion and delivery of a Promissory Note ("Research Note"). The research fee to be paid to Coral by Agro, denominated in Brazilian cruzeiros, was equivalent to approximately $600,000 in United States currency using the exchange rate printed in the Wall Street Journal on December 30, 1982, the day the contract was signed. Agro paid $75,000, the cash portion of the purchase price, on December 30, 1982. The Research Note dated December 30, 1982, was in the face amount of NCr$130,305,000 with interest at 10 percent per annum. On January 31, 1983, Coral assigned the Research Note to M.R.T. Medical Research Trust ("MRT"), a Liechtenstein trust the beneficiaries of which were employees of Coral including Dr. Fred Stark and Gwyn Williams.

The research agreement between RDP and Coral describes the product to be developed by Coral as:

> A conjugate of Alkaline phosphatase and a monoclonal antibody which is produced by a single mouse/mouse hybrid cell line and which combines specifically in an immunological manner with the characteristic antigen of Shigella K7.

Coral subsequently redesignated the target antigen as Shigella boydii OC7, in a memorandum dated December 2, 1983. RDP agreed to pay Coral NCr$144,270,000 payable one-eighth in cash upon execution of the agreement and seven-eighths by execution and delivery of a Research Note. The research fee to be paid to Coral by RDP, denominated in Brazilian cruzeiros, was equivalent to approximately $600,000 in United States currency using the exchange rate printed in the Wall Street Journal on December 23, 1982, the day the contract was signed. RDP

paid $75,000, the cash portion of the purchase price, on December 23, 1982. The Research Note dated December 23, 1982, was in the face amount of NCr$126,236,250 with interest of 10 percent per annum. On January 31, 1983, Coral assigned the Research Note to MRT.

The research agreement between Alfa and Coral describes the product to be developed by Coral as:

> A conjugate of Alkaline phosphatase and a monoclonal antibody which is produced by a single mouse/mouse hybrid cell line and which combines specifically in an immunological manner with the characteristic antigen of Pseudomonas aeruginosa 6.

In exchange Alfa agreed to pay Coral NCr$144,270,000 payable one-eighth in cash upon execution and delivery of a Research Note. The research fee to be paid to Coral by Alfa, denominated in Brazilian cruzeiros, was equivalent to approximately $600,000 in United States currency using the exchange rate printed in the Wall Street Journal on December 23, 1982, the day the contract was signed. Alfa paid the $75,000 cash portion of the purchase price on December 27, 1982. The promissory noted executed on behalf of Alfa on December 23, 1982, was in the face amount of NCr$126,236,250 with interest of 10 percent per annum. On January 31, 1983, Coral assigned the Research Note to MRT.

The Research Notes in favor of Coral from Agro, RDP, and Alfa paid an interest rate of 10 percent annually, and had no actual payments due for the first 7 years. One-fourth of the principal of the Research Notes plus interest accrued on that portion of the principal was due

in 1989, 1990, 1991, and 1992, respectively, prepayable if there were proceeds from commercialization of the product. These liabilities of Agro, RDP, and Alfa were not indexed for inflation, or linked to the exchange rate of any currency, including the U.S. dollar.

In 1982 when the Partnerships were formed and the liabilities were made in favor of Coral, Brazilian currency was undergoing hyper-inflation and devaluation against the dollar. From 1974 to 1978, inflation in Brazil averaged 38 percent annually. The rate reached 77.2 percent in 1979, 110.2 percent in 1980, 95.2 percent in 1981, and 99.7 percent in 1982. Based on the persistently high inflation rate in Brazil, and international debt crisis inaugurated by Mexico's announcement that it was unable to meet payments due on its external debt in August of 1982, and permissive wage indexation in Brazil, the consensus forecast of the performance of the Brazilian economy predicted that the annual rate of inflation would remain high while declining modestly to 87 percent in 1983, 80 percent in 1984, and 75 percent in 1985 and 1986. See International Economic Analysis, Latin American Economic Outlook: Brazil (Washington, D.C. December 1982), p. 5. The average projection of approximately 40 private forecasters surveyed every month by the Blue Chip Economic World Scan newsletter expected inflation of 88 percent in Brazil for 1983, as reported in the December 15, 1982, issue. The same group predicted on average that Brazil's inflation would run at 79 percent in 1984, 74 percent in 1985, 65 percent in 1986, 64 percent in 1987, and 59 percent in 1988. The promoters of the Partnerships, as well as many of the investors, were aware of these predictions of Brazil's inflationary economy.

Over the decade ending in 1982, both interest rates and the exchange rate of cruzeiros/dollars in Brazil tended to rise with inflation.[3] In 1982 investment banks were lending money at 8.5 percent monthly or 166 percent annually. Depositors in the Letra de Cambio were receiving 7.25 percent monthly on their deposits during the first week of December 1982 while bank certificates of deposit were paying 7.6 percent monthly or 140 percent per annum. After years of high inflation, the standard practice in Brazil for all but very short-term debt was to incorporate monetary correction or indexation clauses into financial contracts. Making long-term loans in cruzeiros with nominal interest rates and no monetary correction or indexation clause like the Research Notes executed on behalf of Agro, RDP, and Alfa in favor of Coral was not a normal business practice for transactions in 1982.

Subsequent to 1982, inflation was far worse than predicted in December of 1982. Brazil's inflation rose to the range of 210-235 percent annually in 1983-1985 while the interest rates and cruzeiro/dollar exchange rate increased accordingly.[4] In 1986 the Brazilian government launched the Cruzado Plan replacing the cruzeiros with the cruzado at 1,000 to one and freezing all prices and wages to halt inflation in Brazil. The result was an annual inflation rate of about 65 percent through 1986 and serious product shortages, excess demand, and a large fiscal deficit. The annual inflation rate soared to over 1,000 percent in the early months of 1987. By the end of

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[3]See footnote at end of case.

[4]See footnote at end of case.

1987, inflation had receded to its normal monthly rate of about 10 percent.

Assuming an annual inflation rate of 87 percent in 1983, 80 percent in 1984, and 75 percent thereafter (as predicted by some economic forecasters in late 1982), the dollar amounts that would be required to make payments to Coral on the Research Notes were $3,840 in 1989, $2,330 in 1990, $1,400 in 1991, and $840 in 1992.[5] In fact, the Brazilian currency had so depreciated that on January 19, 1988, each partnership could have satisfied its debt to Coral by payment of $184.

RDP and Alfa entered into Evaluation and Option Agreements with Technology License Company, Ltd. ("TLC") dated May 16, 1984, and September 30, 1985, respectively. TLC was originally owned by Inpro, Campbell's wholly owned corporation. Later, Murex Corporation of Norcross, Georgia ("Murex") acquired TLC. Murex was founded by Campbell, who is the controlling shareholder. The license agreements gave TLC, (1) a nonexclusive right to manufacture, distribute, use, and sell the monoclonal antibody conjugate for 15 months to evaluate the marketability of the conjugates, and (2) a right of first refusal after evaluation to acquire each partnership's right, title, and interest in the conjugate. RDP and Alfa were to receive two to four percent of the net sales price of each item of the product sold during the 15-month evaluation period. In the licensing agreements RDP and Alfa acknowledged their liability to MRT and authorized TLC to pay royalties to the trust until the liability on their notes had been satisfied. If TLC ac-

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[5]See footnote at end of case.

quired RDP's or Alfa's interest in the conjugate at the end of the evaluation period, Alfa would continue to receive two to four percent of the net sales price of the products sold for 15 years.

Agro and RDP entered into separate License Agreements with TLC dated December 23, 1985. RDP's License Agreement did not refer to its 1984 Evaluation and Option Agreement with TLC. The License Agreements gave TLC, (1) an exclusive right to manufacture, distribute, use, and sell the monoclonal antibody conjugate, using a good faith effort, for 36 months to evaluate the marketability of the conjugates, and (2) the option to acquire Agro's and RDP's right, title, and interest in the conjugate. TLC agreed to pay each partnership an initial minimum royalty by executing a promissory note on the date of the License Agreement in the amount of NCr$120,000,000 payable in 3 years. TLC also agreed to pay each partnership a second minimum royalty 1 year from the date of the License Agreement by executing a similar promissory note in the amount of NCr$120,000,000, payable in 3 years.

In addition, TLC agreed to pay the two partnerships three to five percent of the net sales price received for any products made from the conjugate, creditable against the minimum royalty amounts, during the evaluation period. TLC agreed to pay any amounts in excess of the minimum royalty to MRT in satisfaction of the Research Notes Coral assigned to MRT. The License Agreements provided that if TLC opted to acquire the title to the monoclonal antibody conjugates after the evaluation period, TLC would pay three to five percent of the net sales price to the partnerships for 15 years.

Agro and RDP both amended their License Agreements with TLC on the same date that they entered into the original agreements. The amended agreements were similar except (1) the royalty was reduced to two to four percent of net sales prices; (2) TLC had no obligation to commercialize the conjugates; (3) all right, title, and interest in the conjugates vested in TLC after it gave the Partnerships the second minimum royalty note; and (4) TLC's failure to make royalty payments would not affect its title to the conjugates.

Also, on December 23, 1985, Agro and RDP each entered into a three-party agreement with TLC and Diagnostic Holdings Ltd. ("DHL"). DHL assumed TLC's obligations to the two partnerships, Agro and RDP released TLC from its obligations pursuant to the first contract, and TLC agreed to pay DHL the sums it would have paid the two partnerships pursuant to the amended contract.

As of January 1988, no payments had been made on any of the Partnerships' Research Notes that Coral had assigned to MRT. Although provisional patent applications were filed by Agro, RDP, and Alfa covering the research Coral had done for the Partnerships, no patents were granted.

On May 20, 1985, Coral successfully completed for RDP development of a conjugate of alkaline phosphatase and a monoclonal antibody which combines in an immunological manner with Shigella boydii OC7. On November 27, 1985, Coral successfully completed for Agro the development of a conjugate of alkaline phosphatase and a monoclonal antibody which combines in an immunologi-

cal manner with Escherichia coli K-99. On November 27, 1985, Coral successfully completed for Alfa the development of a conjugate of alkaline phosphatase and monoclonal antibody which combines in an immunological manner with Pseudomonas aeruginosa 6.

The Coral projects had the stated goal of using monoclonal antibody conjugates to develop more rapid and accurate identification and diagnosis of disease in clinical laboratories, hospitals, and research laboratories, and in doctors' offices. The projects were set up and promoted to return more in Federal income taxes to each investor than any cash the investor would be required to invest. On one occasion Campbell stated that the Coral program was first and foremost a tax shelter and only secondarily a money-making activity. During presentations concerning the Coral projects, Campbell would inform potential investors of a possible 8-to-1 deduction and low economic risk due to the high probability of the Brazilian cruzeiros' depreciation against the dollar. Moreover, potential investors received a history of the declining value of the cruzeiro.

Agro, RDP, and Alfa at all times relevant maintained their books and records and filed their Federal income tax returns on the basis of the calendar year using the accrual method of accounting. The Partnerships elected to treat research and development expenditures as expenses not chargeable to capital accounts pursuant to section 174.

The partners of Agro who testified at trial were Dr. Donald Brotherman, Martin Greibat, Allen Poe on behalf of Black Champ Enterprises, and Philip Robertson on

behalf of Bavaro Investments. In the aggregate they held about 48 percent of the partnership interests in Agro.

Dr. Brotherman is a physician specializing in ophthalmology who owned a four-percent interest in Agro and interests in two other Coral partnerships. He learned about Agro from William Bailey, an accountant in the accounting firm of Bailey, Vought and Robertson, in 1982.

Martin Griebat is a self-employed designer of clinical machinery who designed a packaging machine for the partnership. He had invested in eight Coral partnerships which reduced his adjusted gross income by $734,936.94. Griebat could not remember at trial the names the other Coral partnerships he had invested in.

Allen Poe is a partner of Black Champ Enterprises which purchased a 20-percent interest in Agro. Black Champ Enterprises had invested in six Coral partnerships other than Agro. Poe did not know the names of the other Coral partnerships in which Black Champ Enterprises invested and did not know what research they did.

Philip Robertson is a CPA and is a partner in the firm Bailey, Vought and Robertson. He is a partner in Bavaro Investments Company ("Bavaro") with Bailey and Vought. Bavaro owns a four-percent interest in Agro and is the partnership's tax matters partner. At trial, Brotherman, Griebat, Poe, and Robertson did not know their fellow partners and were not familiar with the financial status of the partners despite the fact that Agro was a general partnership and each of the partners were jointly and severally liable for all partnership liabilities.

The partners of RDP who testified at trial were Ben Skinner, Danny Wash, Ellis Hardin, Gary Bergman, James McGee, Paul DeGroat, Edward Bach, Ruth Sutton, Robert Winn, Thomas Hennessey, and Donald Spear. Ben Skinner, a program administrator at Texas Instruments heard about Coral from a friend and became a four-percent partner in RDP. Although he was familiar with the history of the declining cruzeiro, Skinner did no independent investigation into his investment in RDP, and was not familiar with Coral or the value of the services performed by Coral. Skinner did not know many of his fellow partners and was not familiar with their financial status even though he was jointly and severally liable with his partners for all partnership liabilities. Moreover, Skinner did not know what his share of RDP's liabilities was. Prior to his investment in Coral, Skinner had no experience or expertise with respect to medical research, manufacturing or marketing pharmaceuticals, or medical products. Since his initial investment, Skinner's partnership activities have consisted of attending one meeting, participating in several telephone conversations, and reading articles about monoclonal antibodies, none of which he remembered at trial.

Danny Wash is an attorney with a general practice who heard about Coral when Spear gave a presentation on a radio show. Spear was a salesman for Coral and also was the tax matters partner for RDP. Spear discussed the history of the cruzeiro devaluation with Wash, after which Wash purchased a four-percent interest in RDP. Prior to the trial, Wash had never seen the RDP Agreement, and he did not know who negotiated it on behalf of the partnership. Wash's understanding was that he was only liable for his percentage of the cruzeiro note to Coral, but

he was not sure whether there was an agreement limiting his liability on the note. In 1982 Wash could not have paid off $525,000 liability, and did not know who his other partners were besides Don Spear. Prior to his investment in Coral, Wash had no experience or expertise with respect to medical research, manufacturing, or marketing. He has never requested any information regarding the value of the services to be performed by Coral. He did not acquire any information about monoclonal antibody research and never investigated the possibility of commercial exploitation of the research.

Ellis Hardin is an Electronic Test Technician at Rockwell International. He has a college degree. He heard of Coral from Don Spear on the radio, and purchased a 5⅓ percent interest in RDP. Spear advised Hardin that Coral would save him money on taxes. Hardin is not familiar with his other partners and had never spoken to any of them prior to the trial. At the time of trial he did not know the extent of the partnership liabilities. Prior to investing in RDP, Hardin had no experience or expertise with respect to medical research, and he did not try to inform himself about the research that was going to be done by Coral. Since he invested in Coral, Hardin has devoted no time to partnership activities. He was not aware of any partnership meetings.

Gary Bergman is a pilot with American Airlines. After talking with Spear about the tax aspects of the Coral transaction, he purchased a 5⅓ percent interest in RDP. Aside from talking with Spear and a couple of friends, and reading magazine articles, Bergman did nothing to investigate the potential profitability of the Coral research. He

does not know many of his partners personally, and he left the partnership affairs to Spear.

James McGee manages rental properties as an occupation. He is a four-percent partner in RDP. Aside from talking to Spear and some of his partners and reading magazine articles, McGee did nothing to investigate the potential profitability of the Coral transactions although he did discuss the tax implications of the Coral transactions with Spear.

Paul DeGroat was an electrical engineer with Xerox for 23 years until his retirement in 1987. After consulting with Don Spear, he purchased a four-percent interest in RDP. DeGroat has met only a few of his partners. He did not know if he was liable on a cruzeiro note or how much money he though RDP would make. He left any decision about the direction for medical research to Spear. He did not know when the Research Note to Coral was due.

Edward Bach is a photo retoucher. He purchased a 6⅔ percent interest in RDP after hearing Spear on the radio. Bach does not know any of his partners. He had no idea what RDP's financial projections were. He did not have enough resources to pay any demand on his $40,000 note to the partnership. When he applied for a mortgage in 1983, he did not list his $40,000 note to the partnership as a liability.

Ruth Sutton heard of RDP from Steve Wisdom, who is Don Spear's nephew and employee. She acquired a four-percent partnership interest by investing $3,400 cash and signing a note for $25,000. Sutton testified that

Wisdom told her she would probably not have to pay off her note because it was denominated in cruzeiros and could be expected to devalue to insignificance by its due date in 7 or 8 years. Sutton's main purpose for entering into the partnership was to save money on taxes. Spear told Sutton that "paying your income tax is optional * * * tell me what you would like to pay in income tax, and I will provide you with the deductions to get you down to where you will pay that much."

Robert Winn is a pilot for American Airlines who heard about Coral from Spear. Winn invested $3,269 cash and a $25,500 note and acquired a four-percent interest in RDP. He had faith that Spear would not ask him to pay off the note because of "stipulations of the way the business was set up." Winn did not know of 16 of his 18 partners. He did not know if the partnership signed a cruzeiro note. He thought there was a transfer of money to a foreign currency, but he was not sure how that was done. He did not know how the partnership paid for the research. Winn has never attended a partnership meeting. He assumed the partnership received a formula from Coral but he does not know the whereabouts of that formula. He has never requested any information about the value of Coral's services. Other than talking with Spear, he has never investigated the possibility of commercial exploitation of the research. Winn talked with Spear about that tax aspects of the Coral investment. Tax relief was the reason he entered into his investment.

Thomas Hennessey is a pilot for Northwest Airlines. He became a 9⅓ percent partner in RDP on the advice of Spear. Spear gave Hennessey a printed form indicating the exchange rate history of the cruzeiro from 1970 to

June of 1982. Spear also gave Hennessey a chart indicating what the partnership would mean to him personally. The chart assumes the cruzeiro will devalue 60 percent per year and indicates an investor in the 50 percent tax bracket would receive tax benefits totaling $14,752 for a $5,000 cash investment. Hennessey could not have paid off a $500,000 note either in 1982 or at the time of trial.

Marc Geller was the only partner from Alfa to testify at trial. Geller's occupation for the last 15 years has been investing. He has both a law degree and a masters in taxation. He thought it was a potentially viable investment, and the tax benefits attracted him. Geller knew that the Research Note Alfa gave Coral was denominated in cruzeiros, that the cruzeiro had been extremely volatile currency, and that there was a reasonable likelihood that the cruzeiro would devalue over time which would reduce the payment from Alfa to Coral. Aside from obtain the one-sentence letter from Dr. Carlton recommending that the partnership select Pseudomonas aeruginosa 6 for its research project, neither Geller nor Alfa consulted with anyone else about the project or its profit potential. Geller did not know who negotiated the research and development agreement on behalf of the partnership. Geller purchased a 16.53 percent interest in Alfa. Geller's $14,666.666 cash investment in Coral reduced his 1982 adjusted gross income by $96,530 and reduced his tax liability by $22,256.

Opinion

The first issue we address is whether the notes denominated in Brazilian cruzeiros given to Coral by Agro, RDP, and Alfa in connection with Coral's undertak-

ing the development of specific monoclonal antibody conjugates were valid indebtedness. Much of the deductions claimed by the Partnerships pursuant to section 174 resulted from claiming liability on the notes denominated in Brazilian cruzeiros. Section 174 allows, at the taxpayer's election, a current deduction for research and experimental expenditures incurred during a taxable year in connection with the taxpayer's trade or business. The Research Notes represented seven-eighths of the amount each Partnership claimed as research and experimental expenditures.

Section 163 allows a deduction for all interest paid or accrued within the taxable year on indebtedness. If indebtedness has no reality or substance apart from anticipated tax benefits, it will be disregarded. *Knetsch v. United States* [60-2 USTC ¶ 9785], 364 U.S. 361 (1960). Neither the deduction for expenses supported by false debt nor putative interest on it is allowable. *Goldstein v. Commissioner* [66-2 USTC ¶ 9561], 364 F.2d 734 (2d Cir. 1966), affg. [Dec. 27415] 44 T.C. 284 (1965); *Levin v. Commissioner* [87-2 USTC ¶ 9600], 932 F.2d 403 (7th Cir. 1987), affg. [Dec. 43,406] 87 T.C. 698 (1986).

We are convinced that the notes signed on behalf of Agro, RDP, and Alfa were not compelled by business realities but rather were incurred solely for expected tax benefits. The notes furnished the leverage needed to create large write-offs to produce tax benefits larger than any current or future cash requirements of the Partnerships. Most importantly, the terms of the indebtedness contravened standard commercial practice. *Levin v. Commissioner, supra.*

The terms of the notes bore no relationship to business practice in Brazil. Unlike standard commercial practice, the notes provided no indexation or monetary correction clauses to protect against devaluation of the principal of the debt. Prior to 1982, Brazilian currency had undergone hyperinflation and devaluation against the dollar. "Petitioner's protest,—'How could we know that inflation would continue,'—rings hollow." *Levin v. Commissioner,* 87 T.C. at 407. In 1982 the annual inflation rate in Brazil reached 99.7 percent and many economic forecasters, including respondent's expert, predicted at that time that the inflation rate would decline only modestly in later years. Reflecting this widely held view, the standard practice in financial transactions in Brazil in 1982 was to incorporate monetary correction or indexation clauses into contracts. Further, the interest rate on the Research Notes was far below market at an annual 10 percent rate, which was a rate that many commercial lenders were charging per month in 1982. High monthly rates of interest were paid on bank deposits, bank certificates of deposits, and automobile loans. The promoters of the Coral projects and many of the investors were aware of the adverse inflationary pressures on the Brazilian cruzeiro. Investors were given historical information on the declining value of the Cruzeiro as part of the promotion of the projects. We believe no one expected to pay any significant part of the "liability" represented by the Research Notes. Indeed, each Partnership's Research Note could have been satisfied in January 1988 by a payment of $184. By contrast, the Partnerships each claimed their Research Note supported $525,000 of research and development expenses and sizable interest deductions.

Moreover, the Research Notes were unnecessary to the economics of the research undertaking. The $75,000 cash payments made by the Partnerships to Corai were more than sufficient to cover the value of the services performed by Coral for the benefit of the Partnerships. The notes were each approximately equivalent to $525,000 in United States currency on the date of execution. Dr. Kennett, the court appointed expert, testified at trial that the task of making antibodies that would react to the specific antigens chosen by the Partnerships, i.e., Escherichia coli K99, Shigella boydii K7 and Pseudomonas aeruginosa 6, was, to a knowledgeable scientist, a manageable undertaking. He found the amount of money charged by Coral to make the monoclonal antibody conjugates exorbitant. He stated, "I could certainly produce all of those antibodies in those three contracts for $200,000, and the work would probably be done in six months, and I would probably have half of that money left to do something else." The Research Notes were superfluous to the transactions, aside from the attempt to secure tax benefits. Because the Research Notes did not comport with business reality, we hold that they should be ignored (as we believe all the investors intended). Consequently, petitioners are not entitled to any distributive share of research and development expense or interest accruing on or in connection with the Research Notes or of any other Federal income tax benefit determined by reference to these Notes.

Next we consider whether petitioners are entitled to any deduction for research and experimental expenditures pursuant to section 174 in connection with the development of monoclonal antibody conjugates by Coral on behalf of the Partnerships. Section 174(a)(1) provides that

research or experimental expenditures paid or incurred during the taxable year in connection with a taxpayer's trade or business may at the taxpayer's election be deducted currently rather than capitalized. The term "research or experimental expenditures" is defined in the regulations as

> expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. * * * [Sec. 1.74-2(a)(1), Income Tax Regs.]

We have found this definition to be "consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product." (Emphasis omitted.) *Mayrath v. Commissioner* [Dec. 26,624] 41 T.C. 582, 590 (1964), affd. [66-1 USTC ¶ 9250], 357 F.2d 209 (5th Cir. 1966).

Section 174 requires that the taxpayer's expenditure is for *research* or for *experimental* purposes. Scientific research and development costs for purposes of section 174 includes an attempt to discover or develop a product, or to develop a new technique or procedure. The goal of the research must be scientifically reasonable, but research is more than repeating what has already been done. It requires some element of experimentation.

Petitioner presented one expert witness at trial to testify about the scientific aspects of the transactions, Henry D. Isenberg, Ph.D., Dr. Isenberg has a Ph.D. degree in Microbiology. He is a microbiologist and the Chief of the Division of Microbiology at Long Island Jewish Medical Center. He is also a clinical professor in Medical Microbiology and Immunology at the University of South Florida College of Medicine. Dr. Isenberg is a member and officer of many professional societies and has received many honors in microbiology. He has been the editor of a variety of medical journals and has published numerous articles on topics related to microbiology and health. His field of concentration is epidemiology.

Respondent presented two expert witnesses at trial with regard to the scientific aspects of the transactions, Michael V. Norgard, Ph.D., and Milton R. Tam, Ph.D. Dr. Norgard has a Ph.D. degree in Microbiology at the University of Texas, Southwestern Medical Center at Dallas. He runs a microbiology research program and teaches microbiology and infectious diseases. Dr. Norgard is a member of scientific societies related to microbiology and disease, has lectured on microbiology, and has received many honors in his area of expertise. Dr. Norgard has published numerous articles on microbiology, including several articles on E. coli.

Dr. Tam has a Ph.D. degree in Immunology. He is a Program Manager for Bacteriology and a Senior Scientist with Genetic Systems Corp. He has published many articles on immunology and monoclonal antibodies. At Genetic Systems, Corp., he manages, directs, and supervises programs associated with the development of mono-

clonal antibodies, and their use for immunological assays and diagnostic tests.

Roger H. Kennett, Ph.D., was a neutral, court-appointed expert witness. Dr. Kennett has a Ph.D. degree in Biochemical Sciences from Princeton University and is an Associate Professor of Human Genetics at the University of Pennsylvania School of Medicine. Dr. Kennett has published extensively, including three books and many articles about monoclonal antibodies.

All of the experts were very well-qualified in their respective specialties. Petitioner's expert, Dr. Isenberg, testified to the importance of the monoclonal antibody production in epidemiology, the transfer of disease. Dr. Isenberg is a leading authority on the subject of epidemiology. He does not, however, have the expertise to comment on the particular scientific processes at issue in this case. We, therefore, do not give much weight to Dr. Isenberg's testimony on monoclonal antibodies. We relied heavily on the opinions of Drs. Kennett, Norgard, and Tam to analyze the scientific aspects of the monoclonal antibody conjugate production.

We hold that Coral's development of monoclonal antibody conjugates on behalf of Agro, RDP, and Alfa does not qualify as "research or experimental expenditures" as defined in section 1.174-2(a)(1), Income Tax Regs. Producing the monoclonal antibody conjugates was clearly scientific work. The projects required a laboratory and trained scientists and technicians. the Coral laboratory in Cambridge was adequate, and the Coral staff in Cambridge was qualified for producing the monoclonal antibody conjugates. The services Coral

performed, however, were not investigative in nature. Rather, as Dr. Kennett's testimony reveals, the projects undertaken by Coral were routine. Our discussion at trial was as follows:

> *THE COURT:* If somebody had come to you in 1982 and said, I would like you to produce for me what is asked for in the research contracts here for Shigella, Pseudomonas and E. coli * * * what would you have said about the likelihood of being able to produce the monoclonal antibody?
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> * * *
>
> *THE WITNESS:* There are few sure things in research, but this is so sure that I could say we can do it. I can almost assure them that we would be able to do it within a year. And we will probably get it done much sooner than that.

The contracts here in question did not require Coral to invent or to develop the concept or design of any product. These contracts rather were merely production contracts under which Coral agreed to manufacture or produce certain monoclonal antibody conjugates. *Mayrath v. Commissioner, supra.* Dr. Kennett and Dr. Tam believed that the monoclonal antibodies sold as projects to investors were those that were easy to produce, rather than those that could be useful for any of the Partnership's hoped-for purposes, such as diagnostics.

The primary stated purpose for producing the monoclonal antibody conjugates was for diagnostics. A panel of the monoclonals was proposed for use in a kit to

test for the presence of a particular organism in urine, blood, or stool samples. A simple color change would indicate that the organism was present. Campbell testified that a large number of monoclonal antibodies was needed for this purpose.

Dr. Kennett and Dr. Tam testified, however, that the Coral antigens were not obviously useful for diagnostics. Even if the monoclonal antibodies selected were appropriate, Dr. Tam testified that the ability to test for a specific antigen of the organism does not help the physician prescribe treatment for a patient because the serotype (the antigen pattern of the organism) does not determine the antibiotic susceptibility of a particular bacterium. The physician needs to know only that the organism is, for example, E. coli. When the physician suspects an E. coli infection, he will prescribe initially an antibiotic that he believes to be active against a broad group of organisms, depending on the patient's condition and using his best guess. He will then determine the actual antibiotic susceptibility of that organism by isolating it, growing it on media, and testing it with individual antibiotics to determine to which antibiotic it is sensitive. Based on the results of this testing, which takes 24 to 48 hours, the physician will alter the initial antibiotic prescribed if necessary.

Another problem with the Coral approach is that to test for the presence of one of the organisms, each antigen of that organism must be tested for. E. coli has more than 160 "O" antigens, more than 50 "H" antigens, and more than 100 "K" antigens. Shigella boydii has 15 antigens and Pseudomonas aeruginosa has 17 antigens. To test for the presence of the organism, all of the monoclonal antibodies

against each antigen of the organism would have to be grouped into one kit. Dr. Tam and Dr. Kennett both testified that if more than four or five antibodies are grouped in one solution, the antibodies begin to interfere with each other, affecting the outcome of the test. Of course, each antigen could be tested for separately. In the case of E. coli, however, that would involve 160 different tests just to cover the "O" antigens, which would be both time-consuming and costly. Coral, therefore, was not "researching" to develop a practical commercial test kit.

Even if it was feasible to combine the monoclonal for all antigens of each organism, Coral could not have done so because only some of the antigens for each organism had been sold as projects to investors. Because monoclonals are antigen specific, using only a single monoclonal as the Partnership had planned could have been misleading. A negative report would indicate the absence of that particular antigen while the bacterium with other antigens was present. In short, Coral's research and development plans could not under any circumstances have created a useful testing kit for any of the organisms at issue.

Dr. Tam believed that a viable approach to using monoclonal antibodies for diagnostics would be to search for a single monoclonal antibody that reacts to all antigens or serotypes of the target pathogen. Coral, however, was only locating monoclonal antibodies against each single antigen of the organism. Coral was not researching to find a monoclonal antibody suitable for diagnostics. Instead, Coral was merely producing monoclonal antibodies against single antigens that were not particularly important.

Another weakness in Coral's approach was that its contracts did not specify for what use the monoclonal antibody was being produced. As a result, Coral's production of monoclonals was necessarily incomplete in every project. Coral produced only one of the several subclasses of antibody in a mouse. Some subclasses of the antibodies are more suited to particular types of assays or tests. For example, one subclass would be suitable for a blood test, another for a urine test. Dr. Kennett testified that because Coral did not know what the antibodies would be used for, it should have provided several classes of the antibodies. Coral in fact produced only a single subclass of each monoclonal antibody for each antigen.

Coral kept laboratory notebooks for each of the projects at issue. The state of Coral's lab books, however, evidences the lack of serious research in these cases. A scientist keeps a lab book so that another scientist can follow the steps taken and reproduce the work or experiment. In other words, another scientist should be able to follow the trail laid out in the lab book and duplicate the experiment. The lab books in this case were sloppy and casual, both in the way they were assembled and in the way the information was recorded. The lab books were divided into sections and contained forms to fill in with the results of Coral's efforts to produce monoclonal antibodies. Although the forms if filled in would have provided a lot of necessary information, most of the forms were not filled in. Some sections contained only pages of computer printouts with no explanation.

From the condition of the lab books, we conclude that Coral's investigations were not organized or well supervised. Coral produced the monoclonal antibodies in

a haphazard manner without adequate scientific technique. Coral's substandard effort in keeping the lab books reinforces our view that producing the monoclonal antibodies conjugates did not involve "research or experimental expenditures" within the meaning of section 174.

The next issue we must address is whether petitioners intended to make a profit on the investment in Agro, RDP, and Alfa. To deduct expenses of an activity pursuant to section 212, the taxpayer must show that he engaged in the activity with an actual and honest objective of making a profit. Sec. 1.183-2(a), Income Tax Regs.; *Dreicer v. Commissioner* [Dec. 38,948], 78 T.C. 742, 642, 645 (1982), affd. without published opinion 702 F.2d 1205 (D.C. Cir. 1983); *Fuchs v. Commissioner* [Dec. 41,349], 83 T.C. 79, 97-98 (1984). Although a reasonable expectation of profit is not required, the actual and honest objective of making a profit must be bona fide. *Fox v. Commissioner* [Dec. 40,125], 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner* [84-1 USTC ¶ 9372], 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. *Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner* 734 F.2d 5, 6-7, 9 (3d Cir. 1984). "Profit" in this context means economic profit, independent of tax savings. *Drobny v. Commissioner* [Dec. 43,140], 86 T.C. 1326, 1341 (1986); *Beck v. Commissioner* [Dec. 42,436], 85 T.C. 557 (1985).

Petitioners bear the burden of proving they possessed the required profit objective. Rule 142(a), Tax Court Rules of Practice and Procedure. The profit objective is determined at the partnership level. *Taube v.*

Commissioner [Dec. 43,737], 88 T.C. 464, 478 (1987); *Brannen v. Commissioner* [Dec. 38,834], 78 T.C. 471, 505 (1982), affd. [84-1 USTC ¶ 9144], 722 F.2d 695 (11th Cir. 1984). In making the determination, we give more weight to the objective facts that to the taxpayer's mere statements of intent. *Thomas v. Commissioner* [Dec. 42,136], 84 T.C. 1244, 1269 (1985), affd. [86-1 USTC ¶ 9465], 792 F.2d 1256 (4th Cir. 1986); *Surloff v. Commissioner* [Dec. 40,419], 81 T.C. 210 (1983).

Section 1.183-2(b), Income Tax Regs., provides a list of factors to be used in determining the existence of a taxpayer's profit objective. These factors include: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer and his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. The list is intended to provide objective standards based upon prior case law. No one factor is determinative. Sec. 1.183-2(b), Income Tax Regs.; *Abramson v. Commissioner* [dec. 42,919], 86 T.C. 360, 371 (1986). Based upon the record before us, we find that petitioners' activity with Coral was an "activity not engaged in for profit" within the meaning of section 183.

The taxpayers in these cases were general partnerships. The intent of the partners, therefore, is relevant to determine the partnerships' intent. The

partners who testified at trial held 48 percent of the partnership interests in RDP, and 16.53 percent of the partnership interests in Alfa. We considered the testimony of all of the partners who testified. We can assume that testimony of the partners who were not at trial would not have been any more favorable to petitioners' position. *Wichita Terminal Elevator Co. v. Commissioner* [Dec. 15,171], 6 T.C. 1158 (1946), affd. [47-1 USTC ¶ 9253], 162 F.2d 513 (10th Cir. 1947).

The testimony reveals a distinct lack of concern by the partners about the financial condition of either the partnership or their partners, a lack of understanding or interest in the partnership's liabilities, management or business, and a shallow, if any, investigation into the potential profitability of the partnership's project. While each general partner was jointly and severally liable for all of the partnership, most of the partners did not know the identity of or the financial status of the other partners in their partnership. The partnerships never made any significant profits. The tax write-offs for research and development, on the other hand, were very large. Of course, given the near certain decline in the value of the cruzeiro and the projected cash flow from promised tax benefits, there was little reason to be concerned about liability on the partners' notes because the partnerships' Research Notes to Coral would require de minimis payments, if any. Many of the partners knew the history of the cruzeiro devaluation at the time of their investment.

The participation by most of the partners in partnership activities was minimal. Some partners had attended one partnership meeting while others knew nothing about partnership meetings. The majority of the

partners did not spend any significant amount of time pursuing partnership activities. The partners left the operation and management of the partnership to one partner, or to a partnership or corporation that was not a partner.

Most of the partners did not have any experience with medical research, manufacturing, or marketing. Some of the partners had read magazine articles about monoclonal antibodies, but could not remember what they had read at the time of the trial. Most partners had done nothing further to investigate the possibility of commercial success of the ventures. They did not request any information about the value of the research that Coral was to perform, or about monoclonal antibody research. Each partnership paid $75,000 cash and executed a note for a cruzeiro amount equivalent to $525,000 on the date of execution, for services that were worth no more than $75,000. The partners for the most part were not aware of the rights of their partnership in exploiting the product of the research Coral agreed to perform.

The legal rights of the investors in the monoclonal antibody conjugates was unclear. Coral agreed only to produce a specific monoclonal antibody conjugate for each partnership. The agreements do not specify the amount that Coral was obligated to produce or in what form Coral was to deliver the monoclonal antibodies. Coral did not have any obligation to package or market the conjugate after it was produced. Although the stated goal of the Coral projects was to use the monoclonals for diagnostics, Coral did not agree to incorporate the monoclonal antibodies into any form suitable for commercial use. Because Coral agreed to produce for each partnership a

monoclonal antibody against only one antigen of an organism, the monoclonals could not have been packaged into a test kit in any event.

The partnerships did enter into marketing agreements with TLC. If TLC marketed a product incorporating the monoclonal antibody conjugates, the partnership was entitled to two to four percent of the net sales price of the product. TLC's right to exploit and market the monoclonal antibodies, however, was limited by the problems with the Coral "research" that we have already identified. Even if combining monoclonal antibodies against all antigens of an organism was feasible, the record does not show that TLC either possessed or could have obtained all of the antibodies. Coral was not researching to find a monoclonal antibody that could have been marketed successfully, such as one monoclonal that would react to all antigens of an organism. The monoclonal antibody conjugates produced by Coral that the partnership licensed to TLC were not marketable.

We conclude that Agro, RDP, and Alfa lacked an actual and honest profit objective in the transactions with Coral, and that they entered into the transactions in issue solely for the tax benefits. To the extent any partnership incurred otherwise allowable deductions, those deductions are limited to income realized.

Decisions will be entered for the respondent.

[This chart is in reference to footnote[3].]

	72	73	74	75	76	77	78	79	80	81	82
Annual Inflation Rate[a]	15.7	15.5	34.5	29.4	46.3	38.8	40.8	77.2	110.2	95.2	99.7
Percent Increase in Exchange Rate	10.3	0.0	18.9	22.0	35.2	30.4	29.7	92.7	61.7	95.3	95.8

[a] General price index, Getuli Vargas Foundation, December-December.

[This chart is in refrence to footnote[4].]

Brazil: Inflation and Exchange Rate, 1982-87

	82	83	84	85	86	87
Annual Inflation Rate[a]	99.7	211.0	223.8	235.1	65.0 [b]	210.05 [c]
Exchange Rate	180.0	577.0	1848.0	6200.0	13.65 [b]	46.0 [d]
Percent Increase in Exchange Rate	95.8	220.6	220.3	235.5	120.2 [b]	209.0 [c]
Percentage of Dec. 1982 value (dollar/cruz.)	100.0	43.8	13.7	4.1	1.8	0.5

[a] General Price Index, Getulio Vargas Foundation

[b] 1982-85 cruzeiros/$: 1986-87: cruzados/$
(currency converstion reform: 1,000 Cruzeiros = 1 Cruzado).

[c] First 7 months

[d] July

Source: International Financial Statistics and Conjuntura Economica, various issues.

[This chart is in reference to footnote[5].]

Value of Cruzeiro Promissory Notes

Year	89 *(7th)*	90 *(8th)*	91 *(9th)*	92 *(10th)*	Total
Cruzeiro payments: (1,000)					
Principal	31,559	31,559	31,559	31,559	126,236
Interest	22,091	25,247	28,403	31,559	107,300
Total	53,650	56,806	49,962	63,118	233,626
Expected Exchange Rate (cruzeiros per dollar)	13,960	24,428	42,749	74,816	n/a
Dollar payments	3,840	2,330	1,400	840	8,410

ORDER ON REHEARING

Appeal from the United States Tax Court

ON PETITION FOR HEARING

(April 22, 1991)

Before REAVLEY, JONES and SMITH, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ Thomas M. Reavley
United States Circuit Judge

STATUTES

I.R.C. section 174 (1954).
Section 174. Research and experimental expenditures

(a) Treatment as expenses.—

(1) In general.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) When method may be adopted.—

(A) Without consent.—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this subsection for his first taxable year—

(i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(ii) for which expenditures described in paragraph (1) are paid or incurred.

(B) With consent.—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this subsection.

(3) **Scope.**—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

(b) Amortization of certain research and experimental expenditures.—

(1) **In general.**—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, research or experimental expenditures which are—

(A) paid or incurred by the taxpayer in connection with his trade or business,

(B) not treated as expenses under subsection (a), and

(C) chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion),

may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratable over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the

taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustment to basis of property).

(2) Time for and scope of election.—The election provided by paragraph (1) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

(c) Land and other property.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

(d) Exploration expenditures.—This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

I.R.C. section 183 (1954).
Section 183. Activities not engaged in for profit

(a) General rule.—In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions allowable.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity not engaged in for profit defined.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than the one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) Presumption.—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary or his delegate establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

(e) Special rule.—

(1) In general.—A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity. For purposes of the preceding sentence, a taxpayer shall be treated as

not having engaged in an activity during any taxable year beginning before January 1, 1970.

(2) Initial period.—If the taxpayer makes an election under paragraph (1), the presumption provided by subsection (d) shall apply to each taxable year in the 5-taxable year (or 7-taxable year) period beginning with the taxable year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 2 or more of the taxable years in such period exceeds the deductions attributable to the activity (determined without regard to whether or not the activity is engaged in for profit).

(3) Election.—An election under paragraph (1) shall be made at such time and manner, and subject to such terms and conditions, as the Secretary or his delegate may prescribe.